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Increases in the money supply do not produce any economically determined effects. It is obvious that these will be entirely contingent upon the use to which the new quantities are applied, and the way they take through the economic organisms… The crucial question is whether the agencies finance consumption or production, whether they serve purposes which will increase the social product or purposes which will not.

— Joseph A. Schumpeter, *Business Cycles: A Theoretical, Historical and Statistical Analysis of the Capitalist Process*, 1939

DEBT, DELUSION, DECEPTION

After the convulsions from the French and Dutch rejection of the proposed European Union Constitution, general attention has returned to the single most important question for the global economy. That is the state of the U.S. economy and its further prospects.

While surveys out of Europe have been consistently poor for many weeks, the consensus, conspicuously orchestrated by the Fed's pundits, saw no more than a "soft patch" in the United States to be quickly followed again by the accustomed high rates of economic growth. In strict contradiction, we have constantly warned of worse to come.

The Federal Reserve's flow-of-funds statistics for the first quarter are just out. Evidently, credit creation has been completely taken over by the printing press. In the quarter, overall credit skyrocketed by $2,976.1 billion, close to $3 trillion, at annualized rate.

Nonfinancial credit was up $2,411.4 billion. This compares with an increase of $1,943.2 billion in the fourth quarter of 2004 and $836.2 billion in 2000. Over those four years, credit growth in the nonfinancial sector has literally tripled. To us, this looks more like monetary lunacy than monetary policy.

This skyrocketing wedge between debt growth and GDP growth is definitely the most spectacular and most frightening phenomenon of the economic and financial development in the United States. In relation to lagging income growth, the wedge is considerably bigger. Yet it receives zero attention by the Federal Reserve and the permanently bullish consensus.

Due to higher inflation, higher short-term rates and compound interest, ever-increasing amounts of credit are required to maintain their effects on spending and asset prices.

Signs of a slowing global economy are abounding, led everywhere by the manufacturing sector. Downward surprises are chronic. The U.S. economy is no exception.

Our highly critical assessment of the U.S. economy is mainly determined by two extremely negative considerations: *First*, its chronic structural imbalances between consumption, saving, investment and debt creation have dramatically worsened since 2000; and *second*, both monetary and fiscal policies have virtually exhausted their stimulatory potential. There is little or nothing left for them to do when the economy slides back into recession.

It is the particular feature of U.S. economic growth since the late 1990s that consumer spending has increasingly outpaced the growth of production. Its counterparts are a collapse of saving out of current income, weak business fixed investment and the soaring trade deficit. Actually, business borrowing goes mostly into mergers, acquisitions and dividend payments.

The most striking hallmark of this escalating divergence between consumption and output in the U.S. economy has been the exploding U.S. current account deficit, presently running at an annual rate of close to $800 billion. This is more than six times its amount of $109.5 billion in 1995.

It seems that U.S. policymakers and economists have yet to realize that this deficit is the economy's great income and profit killer. To offset the implicit huge drag on U.S. domestic production, employment and incomes, the Federal Reserve has kept its money and credit spigots wide open to create alternative domestic demand.

In his congressional testimony on June 9, 2005, Federal Reserve Chairman Alan Greenspan described the U.S. economic situation to be "*on a reasonably firm footing*." Looking at the following monthly figures from the Bureau of Economic Analysis' (BEA) *Personal Income* and Outlays report, we note a dramatic deterioration in income growth and spending growth.

U.S. Personal Income and Outlays (%)

	2004	2005				
	Dec	Jan	Feb	Mar	Apr	May
Personal income, current dollars	4.0	-2.5	0.5	0.5	0.6	0.2
Disposable personal income						
Current dollars	4.3	-3.3	0.4	0.5	0.5	0.2
Chained (2000) dollars	4.4	-3.4	0.3	0.0	0.1	0.1
Personal consumption expenditures						
Current dollars	0.9	-0.1	0.6	0.8	0.6	0.0
Chained (2000) dollars	0.9	-0.2	0.4	0.4	0.2	0.0

Source: Personal Income and Outlays, *Bureau of Economic Analysis*

This table finds very little attention. In reality, it is of eminent importance because it shows changes in consumer incomes and spending on a monthly basis. Given the high share of consumption in GDP, it is the best proxy for current GDP growth. For the first two months of the second quarter, April–May, consumption is up 1.2% at annual rate.

The published numbers for the gains in real disposable income are actually so disastrous that we hesitate to take them at face value. Real disposable income in May 2005 was $8,211.6 billion, down sharply from $8,473 billion in December 2004.

A FRIGHTENING INCOME PICTURE

Assuming a big distortion from December to January, we focus on the four months February–May. Over these four months, the real disposable income of private households edged up a miserable $37.7 billion, equal to an annual growth rate of 1.5%. For comparison, real disposable income grew 3.7% in 2004 and 2.3% in 2003. It seems reasonable to describe this as an income collapse.

Over the same four months, consumer spending in chained dollars surged by $75.7 billion, but with a steep downtrend: February, $32 billion; March $28.6 billion; April, $18.1 billion, May – $3 billion.

There is no secret as to how the American consumer has been pulling this off. It is all about an economy in which demand growth through income creation has been increasingly replaced through inflating asset prices providing the collateral for ever-higher spending on credit. But income creation is not catching up; it is in dramatic decline.

THE TWO CRUCIAL MACRO DRAGS

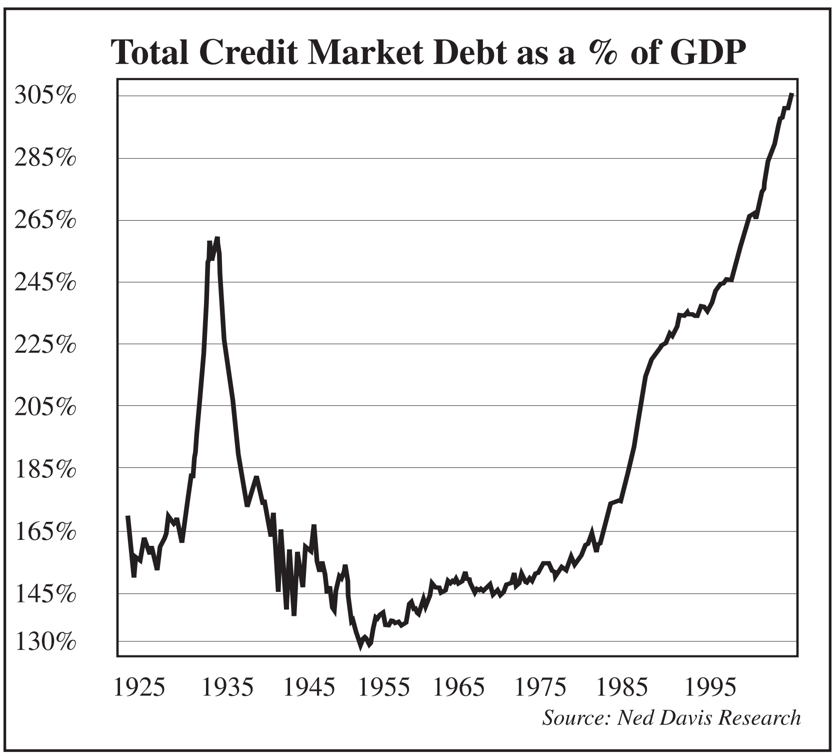
We are looking for the deeper macroeconomic causes behind this rapidly widening gap between consumer spending and consumer incomes. These reside in the two major structural imbalances, which policymakers and economists in the United States stubbornly refuse to regard as a problem.

The paramount reason is the soaring deficit in the U.S. economy's current account, reported at $195 billion for the first quarter of 2005. This sum reflects current spending of many different kinds in the United States. The recipients of this huge amount, however, are foreigners enjoying a corresponding rise in their current incomes.

These big income gains on the part of the surplus countries implicitly have their counterpart in a commensurately big income leakage on the part of the U.S. deficit economy. With its soaring current account deficit now close to $800 billion, or well over 6% of GDP, it would long be in deep recession.

To offset this enormous trade-related income drag cogently requires compensating credit and debt creation to generate alternative demand. That is what the Fed has done with its persistent extreme monetary looseness. Thus the monstrous trade deficit has trapped the U.S. economy in a vicious circle of growing credit excess.

But as the demand for manufactured goods is increasingly met by foreign producers, the alternate domestic credit creation increasingly feeds service jobs, of which a large part is low-paying. Another point to consider is that different types of expenditures have very different aftereffects. Just compare in this respect the difference in income creation between spending for health service and spending for building a new factory. In short, easy money replaces the good jobs that emigrate by bad service jobs.



In our view, gross lack of investment spending with high multiplier effects is America's second biggest macroeconomic deficiency.

In line with Austrian theory, we regard capital spending as the critical mass in the capitalist process, generating all the things that make for true prosperity. First of all, it creates employment, income and tangible wealth from the demand side while the plant and equipment are produced. Then, upon their installment, all these capital goods create employment, productivity and income from the supply side.

And there is still a third point to be considered. *First*, capital investment is self-financing; and *second*, depreciations and their reinvestment create an endless stream of recurrent employment and income without any additions to debt. Investment-driven economic growth, therefore, has a very low debt propensity. In contrast, unproductive government and consumer debt automatically feed on themselves through compound interest.

The chart on the left shows a drastic break in the U.S. economy's debt propensity from the early 1980s, similar to the late 1920s, but considerably worse. In both cases, it had the same two causes: booming consumption and financial speculation.

A VERY DIFFERENT DOWNTURN…

Earlier, we emphasized that the U.S. economy's prospects is presently the all-important question for the

global economy. The popular spin, trumpeted by Mr. Greenspan in particular, is that the U.S. economy possesses such extraordinary resilience and flexibility "*that its imbalances are likely to be adjusted well before they become potentially destabilizing.*"

It is an absurd statement, because flexibility is the last thing the U.S. economy has shown in the past few years. Its one and only flexibility has been in the creation of a housing bubble and the associated credit bubble, while all the structural imbalances — rock-bottom savings, asset inflation and the monstrous trade deficit — have soared to new extremes.

Duly, the U.S. pattern of the economy's downturn in 2000–01 has diametrically differed from the typical, cyclical kind. All past recessions were triggered by monetary tightening, the Fed's response to rising inflation rates. Consistent with tight credit, consumers and businesses slashed their credit-financed expenditures. These were the same components in all economic downturns — consumer durables, business investment and residential building.

This downturn has been unlike anything ever experienced in the annals of the business cycle. While the Fed undid its 1998 rate cuts in the first half of 2000 — raising its federal funds rate in three steps by a total of 1%, to 6.5% — credit flows to businesses and consumers escalated as never before. Yet real GDP growth slowed sharply from 3.7% in 2000 to 0.8% in 2001. It was the first recession to happen under conditions of rampant credit expansion.

But what distinguished the 2001 recession most radically from all past experience was its pattern. The downturn had centered on one single demand component — business fixed investment. With a plunge of 13.1% in 2001–02, it experienced its sharpest fall of all postwar business cycles. In an equally unusual fashion, consumer spending simultaneously surged by 5.8%. Clearly, the extraordinary developing consumer borrowing-and-spending binge moderated the economy's downturn.

…FOLLOWED BY A VERY DIFFERENT UPTURN

The following recovery has been just as diametrically different from past experience. With the lowest interest rates in half a century and the biggest fiscal stimulus in history, the U.S. economy's recovery from its 2001 low has nevertheless been its weakest by far in the whole postwar period by any measure. The broadest popular measure is real GDP growth. It increased during the three years 2001–04 by 9.6%, as against an average of 14% growth over the same period for previous cyclical recoveries in the postwar period.

But there is a second utterly unusual feature in this U.S. economic recovery. Just as in the case of the prior downturn, its pattern differs diametrically from past experience. The normal V-shaped recovery remains grossly missing.

Three aggregates of crucial importance for sustained strong economic growth show persistent, drastic shortfalls. These are business fixed investment, employment and real wage and salary income.

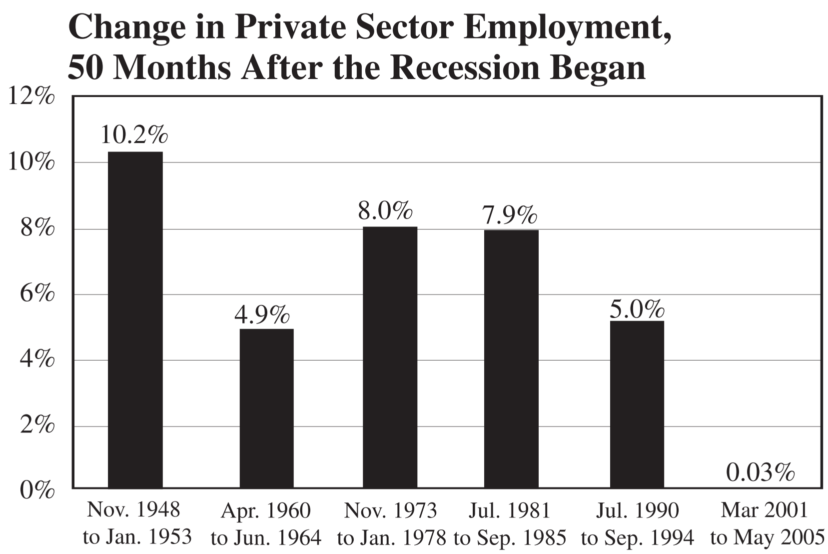
It should be clear that a recovery's composition crucially matters for its vigor and sustainability. Typically, past cyclical recoveries got their immediate, strong traction from pent-up demand for business fixed investment, consumer durables and housing generated by the prior tight money. This time, two critical components went badly wrong: Business fixed investment recovered meekly, and foreign trade went into an exploding deficit.

This U.S. economic recovery has been unique in that it rests on one single pillar — the housing bubble, which the Fed systematically engineered to boost consumer spending through easy consumer borrowing against rising house prices. Ominously, this is occurring against the backdrop of unusual weakness in the growth of employment and wage and salary income.

STAGFLATION FOR THE PEOPLE

The weakest link by far in the U.S. recovery on the income side is the wage and salary component, and instead of improving, it is worsening for three main reasons: *first*, extremely poor employment growth; *second*, wage rates lagging the inflation rate; and *third*, a substantial shift in the employment pattern out of high-paying manufacturing jobs and into low-paying service jobs.

Since March 2001, when the U.S. recession began, employment in durable manufacturing is down 16.2%; nondurable manufacturing, 14.5%; and information, 15.5%. In contrast, the biggest job gains occurred in education services, up 14.3%: health care and social services, up 11.3%: and leisure and hospitality up 6%.



Source: JobWatch, Economic Policy

Although employment in the private sector recovered in 2003–04, it is barely back to its prerecessionary level. Overall, payroll jobs are up 836,000 since then, of which the public sector contributed 803,000.

The net effect of those three negative influences on wage and salary incomes is that *real average gross weekly earnings*, as published every month by the Bureau of Labor Statistics (BLS), have virtually stagnated since 2000. In March 2005, they amounted to $276.08, as against $275.62 in 2000. They peaked in September 2004 at $278.93 (numbers in 1982 dollars).

Reliable sources put the shortfall in private nonfarm payrolls at more than 10 million jobs, compared to past economic recoveries. Yet you will not see a trace of them in the unemployment numbers. They have vanished because of a falling participation rate and discouraged workers. Taking these into account, the U.S. unemployment rate would be around 12%.

Consumer price inflation hit 3.5% (year over year) in May 2005, but average wages and salaries have increased just 2.6%. Hours of work were unchanged. For America's working population, there never was a recovery. It faces stagflation.

As bad as the employment and wage numbers are, they are probably significantly overstated via the hundreds of thousands of fictitious jobs contributed by the business net birth/death model. In May, it produced 207,000 jobs, as against 78,000 new jobs reported. In April, there were 257,000 net birth/death jobs, compared with 274,000 reported new jobs.

The underlying assumption, as we have repeatedly explained, is that small businesses not captured by the BLS survey are creating these jobs. Essentially, the BLS is assuming a hiring boom by small businesses. The justification is their secret.

A MAJOR STRUCTURAL BREAK

This juxtaposition of excess consumption and extremely poor wage income generation cries for an explanation, of course. For the bullish consensus, it has a perfectly good reason in the U.S. economy's superior productivity performance. Considering that since 2000, the job gains have been concentrated in sectors at the bottom of the occupational hierarchy, this explanation appears definitely phony. New relatively high-wage jobs (in construction and real estate service) were mainly related to the housing bubble.

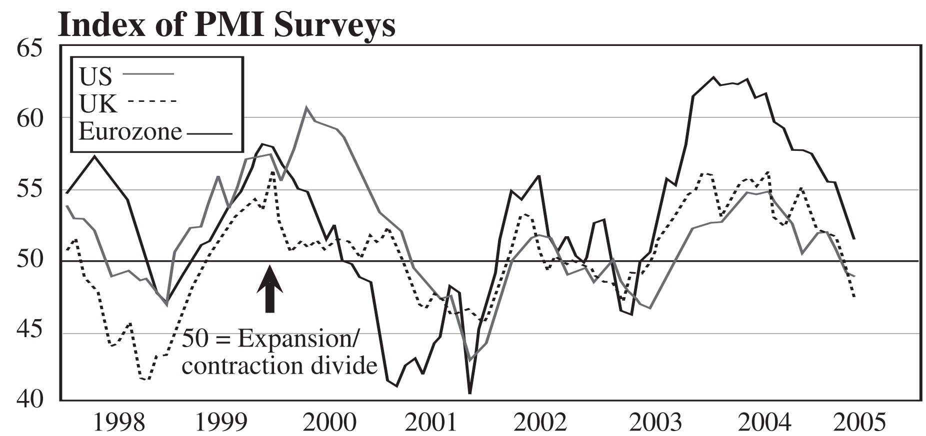
Manufacturing, notorious for high productivity growth, has been the big loser during this recovery. Its employment growth actually peaked in 1979, at 21 million. Over the following 21 years, it lost 2.8 million jobs, but during the four years 2000–04, it shed 3 million jobs, pushing its employment down to 14.3 million.

In general, American policymakers and economists take this demise of manufacturing with ostentatious unconcern. That is a great mistake. First of all, for every country, manufacturing is the main source of foreign

exchange earnings. In the second place, it exerts enormous leverage upon the whole economy through its normally high investment ratios and extensive outsourcing of services, while its direct share in output may look rather modest.

Moreover, due to its central role, manufacturing notoriously leads economic downturns and upturns. Therefore, we have noted with interest that the raft of surveys from the Institute for Supply Management shows a global decline in industrial production.

In the media, it is generally stressed that the eurozone and the U.K. ISM index have slipped into recessionary, sub-50 territory. But while the U.S. index remained at 51.4 in May, still slightly above that critical level, it shows a much steeper decline from a higher level.



Source: Thomson Financial Datastream, Dresdner Kleinwort Wasserstein Securities

It is a great shortcoming of today's economic discussion that it focuses narrowly on changes in aggregate GDP while completely ignoring crucially important changes in its composition or structure. There is little or no recognition that the U.S. economy has become extremely lopsided toward consumption at the expense of capital investment and foreign trade.

LOOK AT CREDIT

Such a structural shift always has two coincident causes. One is a credit expansion out of proportion to economic activity, and the other is that excess credit always flows very unevenly into the economy, favoring those parts where the borrowers see higher profits. In the U.S. case, the most attractive parts over the last seven or eight years have been consumption and inflating asset markets.

In the first quarter of 2005, nonfinancial credit grew by $2,411 billion, compared with $787.6 billion nominal GDP growth, both annualized. For each dollar added to GDP, $3.05 was added to debts in the sector. For decades, until the late 1970s, this debt-to-GDP ratio was around $1.40 in debt for each $1 of GDP growth. If you include financial credit, debt has been growing at almost four times GDP growth.

Weighing future implications of this debt explosion, it ought to be considered that indebtedness in the past has always been eased by price inflation and rising nominal incomes. This time, income growth is badly lagging.

Escalating indebtedness relative to available incomes is the U.S. economy's big problem. Progressive structural debasement of the whole economy is another one, compounding with the first problem. We think of it as a process of "downward restructuring." Austrian theory describes it as a "shortening of the production structure" or "transition to less capitalistic methods of production."

In essence, those three phrases characterize a shift in the production and employment pattern towards activities employing less capital. In the U.S. case, the most striking example is the shrinking manufacturing sector versus rapidly expanding health and social services. Jobs in this category now outnumber manufacturing payrolls, 14.4 million versus 14.3 million. As recently as 1999, factory jobs outnumbered health and social services slots by 5 million.

China is the conspicuous contrary example of an economy "restructuring upward." With very high domestic

savings available, it is turning its existing production structure increasingly capitalistic with large capital investments. In the same vein, the investment boom is creating rapidly rising employment in the capital goods industries. As a matter of fact, in principle, this is precisely the process through which the industrialized countries have prospered for more than two centuries.

A HISTORICAL PRECEDENT?

Frankly speaking, the above three phrases describe, in essence, an economy in structural demise. Actually, this dichotomy between the U.S. economy and the Chinese economy has a spectacular precedent, which started in the 16th century. John Maynard Keynes describes it in his *Treatise on Money*. This precedent is the economic eclipse of Spain and the prodigious economic rise of England and the Spanish territories in today's Netherlands and Belgium.

From the monetary perspective, the parallel starts with the fact that Spain flooded Europe with money through a soaring trade deficit. The primary originating cause of the import deluge was Spain's gold inflows from Peru. That is precisely America's role today, though instead of gold outflows, it uses its printing press.

Keynes writes:

Evidently in Spain the new purchasing power [from the gold inflows] came straight into the hands of the aristocratic and ruling classes and was soon used by them to bid up the cost of services — the new American wealth was being fully reflected soon after the middle of the 16th century in an enhanced level of wages and not, anymore, in capital accumulation. But in the rest of Europe, the new purchasing power arrived by different channels, namely, those of private commerce… During the 17th century, it was the English and French capitalists, not the Spanish, who were adding enormous increments to their country's wealth.

Keynes fails to mention the great prosperity that the Spanish territories in today's Belgium and Netherlands gathered from Spain's trade deficit and gold outflow. The British rather participated by capturing Spanish gold ships. We have recalled this episode of the Middle Ages to demonstrate and emphasize the horrendous differences in the impact of a credit expansion according to the channel through which it enters an economy; that is, through consumption or through productive trade and investment.

Is this not exactly what we see today in the economic and financial relationship between the United States and China? The U.S. economy appears to prosper on rising house prices, fueling an unprecedented consumer borrowing-and-spending binge, while China transforms its dollar surplus into an industrial investment boom. Spain was impoverished for hundreds of years.

The all-important thing to see is the crucial difference between a consumption bubble and an investment bubble. Consumption bubbles are by their nature always destructive, because they impair investment and foreign trade. An investment bubble is constructive up to a point. But it becomes destructive if it goes to great excess, as it did in Japan in the late 1980s.

WHO NEEDS RESTRUCTURING?

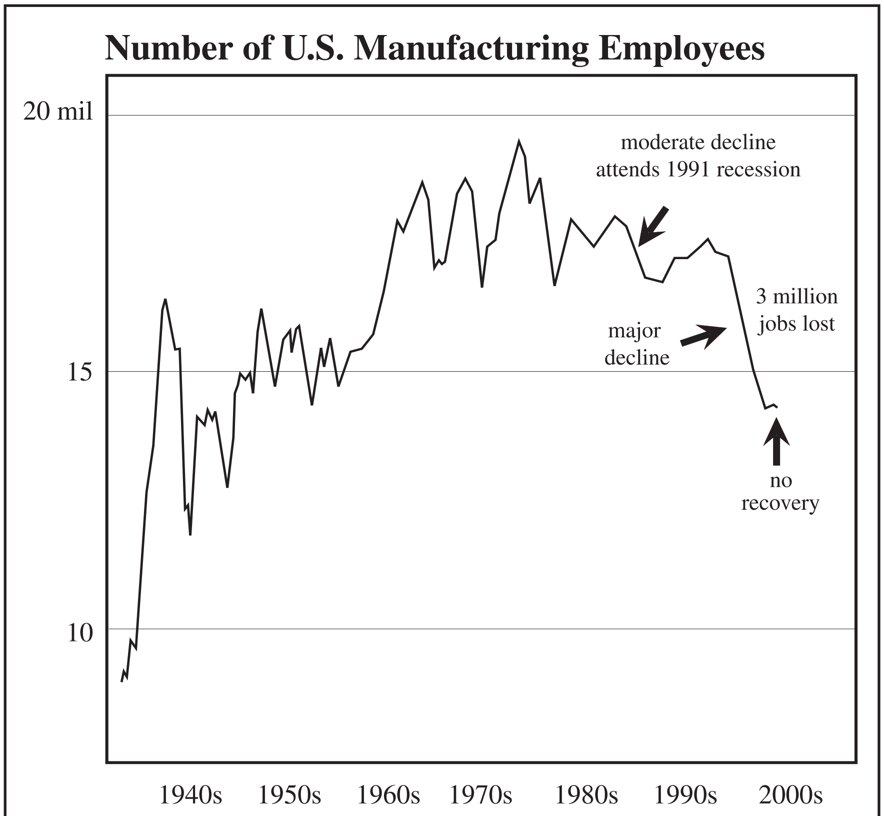
Reading about Europe's urgent need to restructure, we always wonder whether the authors know what they are talking about. In contrast, the U.S. economy is widely seen to be structured to perfection, solving any problems through its extraordinary flexibility.

In his congressional testimony on June 23, 2005, Mr. Greenspan said: *"To maintain a rising standard of living, a dynamic economy such as ours requires a continual shifting of resources toward the most up-to-date technologies, financed not only by savings but also importantly by the depreciation of increasingly obsolescent facilities."*

If you care for the truth and check the relevant statistics, you realize that the exact opposite is happening in the United States. Over the four years since 2000, close to 3 million high-paying jobs in manufacturing have vanished in favor of lowest-paying service jobs.

This shift in the pattern of employment is one reason behind the poor wage and salary performance. But what is the general cause? Is it just a cyclical lag? No, it is definitely structural and bound to worsen, if the underlying corrosive process is not reversed.

The general cause is the phony new wealth creation through inflating stock and house prices boosting consumption by pilfering investment and the trade balance. According to the latest available figures for 2003, it was down 60% from its level in 2000. Asset inflation can actually be thought of as a shortcut to higher consumer spending.



Source: Bureau of Labor Statistics, Elliott Wave International

Historically, wealth has accrued when saving out of current income diverted spending from consumption to investment into building, plant and machinery. Crucial to this process of wealth creation was that the production of these capital goods generated employment and income growth.

In this way, wealth — consisting of income-creating tangible assets — accumulated slowly over generations, but it steadily advanced living standards for the broad population through its intrinsic major employment and income effects. In lockstep, the capital investment bolstered income growth through its productivity effects. People earned rising real incomes from which they could save. It was a virtuous circle of saving, investment and rising living standards.

Today's so-called wealth creation through inflating asset prices lacks any direct employment and income effects in the first place. It accrues through a stroke of the pen due to the conventional practice in the Anglo-Saxon countries to treat the whole existing stock of specific assets as being worth the price of the last marginal trade. In this way, borrowing is rewarded with multiple asset inflation.

There is nil gain in employment and income, but being unreservedly accepted by the banking system, this folly has created collateral in the Anglo-Saxon countries for unprecedented consumer borrowing and spending binges.

Of course, the higher consumer spending generates employment and income for retailers, manufacturers and for sundry others. But these gains are largely cancelled by the simultaneous employment and income losses due to the grossly lacking investment spending and the ballooning trade deficit, both primarily hitting the manufacturing sector.

What the rising house prices truly create is exploding borrowing facilities. Over the four years 2000-04, disposable income of private U.S. households rose $1,452 billion. Spending just $216.9 billion on new housing, they borrowed a net amount $3,082 billion.

To stress the key point: America's poor employment and income performance is definitely not simply a cyclical lag. It is structural, deriving from the circumstance that the overconsumption ravages capital formation and the trade balances. It is a vicious circle, and we see neither facts nor any will in sight to reverse it.

Putting it bluntly, wealth creation through inflating asset prices is no substitute for wealth creation

through capital accumulation. Its low employment and income effects are systemic.

In contrast to the general complacency about the U.S. economy's health, there is wide agreement that slow-growth Europe urgently needs restructuring. It is apparently the consensus view that Europe's poor growth performance is due above all to over-regulation and lack of flexibility.

Undeniably, Europe has a number of economic problems. Europeans, by the way, are the first ones to admit it. To us, Europe's slower economic growth has its decisive cause not at all in the economy's supply side but on its demand side; that is in two aggregates: personal saving and consumption.

In the Eurozone, the average personal savings ratio is close to 9%, as against close to zero in the United States. As to consumer spending, it accounts for 56.9% of GDP in the Eurozone, and for 71% in the United States. During the past few years, it hovered around 90% of GDP growth.

Last but not least, another interesting number: Manufacturing presently accounts for 18.3% of total employment in the Eurozone. In the United States, it is 10.7%.

THE GREATEST WASTE OF CAPITAL

The problems in the U.S. economy are of a radically different nature. First of all, faster GDP growth without employment and wage and salary growth is nothing to brag about. What is increasingly ailing the U.S. economy is the fact that the Fed's protracted, reckless monetary looseness has fueled the greatest waste of capital and capital formation in history.

To paraphrase Schumpeter's quote on the first page: The effect of a credit expansion depends on the particular uses to which the new quantities are applied. The particular uses of the credit excess in the United States were consumer durables, residential building and rampant asset price inflation. Do not forget, however, its ugly flip side: protracted weakness in business investment and the ballooning trade deficit. This, in essence, reflects decreasing capital.

In hindsight, the beginning of this structural degradation of the U.S. economy can be located in the mid-1990s. It appeared promptly and spectacularly in the sliding rate of personal saving and the soaring trade deficit.

In this respect, an evening in December 1996 made history, when Alan Greenspan first uttered those famous words, *"irrational exuberance."* One of the topics on which he touched was the disastrous effect of sliding real estate prices on Japan's economy.

In essence, he said it is hard to know when a speculative market might be due for a sudden contraction. It is also hard to know, he added, when such a contraction might be a disaster. He admitted to have no answers, but one of the questions he posed that night made a memorable impression: *"How do we know when irrational exuberance has unduly escalated asset values?"*

Over the year, the Dow had climbed from 5,117 to over 6,500.

What was to unfold from then on was America's greatest stock market bubble, making millions of Americans rich beyond their wildest dreams — until 2000, when the bubble, all of a sudden, burst.

As stock prices soared, pundits and policymakers invented ever new reasons why this roaring boom was fully justified — deregulation, high-tech, innovation, managerial revolution, real-time information, abolishment of the business cycle, etc. Most people readily believed in the efficient market theory, asserting that market prices always correctly reflect available information.

At work, in reality, was a credit machine that has run completely out of control, particularly since 1998. The main effects of the developing credit excess were rapidly inflating stock prices, which — through their prodigious wealth effects — inflated consumer spending at the expense of investment and foreign trade.

We have recalled this general, gross misjudgment of the U.S. economy's performance during the late 1990s because it appears that American policymakers and most economists still lack any understanding of the serious

structural damages that the protracted, rampant asset price inflation and the associated excess consumption have done to the U.S. economy.

Over the four years since 2000, consumer spending on goods, services and housing accounted for 92.8% of real GDP growth, while nonresidential fixed investment in 2004 was slightly below its level in 2000. This is what the Austrian school qualifies as highly negative *"shortening of the production structure,"* implicitly lowering economic growth in the longer run.

PHANTOM WEALTH THAT IMPOVERISHES

What is wealth creation? Generations of economists once answered this question with one single word. To quote Keynes: *"It is investment, i.e. the increased production of material wealth in the shape of capital goods, which alone increases national wealth."*

Reading mostly favorable forecasts for the U.S. economy, it strikes one that optimism is generally founded on the single hope that the housing bubble will continue in full force to generate consumer demand through equity extraction against the collateral of rising house prices. In contrast, we see an unsustainable housing and consumption bubble deliberately engineered by the Fed, while domestic investment and the trade balance are allowed to rot.

In markets where reason rules, changes in the value of assets are determined by yields expected over time. In the United States, rents from housing have been rising even less than the inflation rate. Actually, nobody expects any acceleration. The only vindication for the soaring house prices is the hope for a "greater fool" buying later at a higher price. To qualify this as wealth creation is absolutely ridiculous.

In any case, the narrow property market is setting a trap. While relatively few transactions at rising prices have catapulted the value of the vast mass of existing house to stratospheric levels, a few transactions at falling prices will devastate wealth with the very same speed and leverage.

The seller of a house, of course, gets a higher price than he paid some time ago. But if he changes his residence to a similar location, he has to pay the same higher price. In terms of comfort and location standards, he has gained nothing at all.

Strictly speaking, his only gain is avoidance of the loss that is common to the community not owning a house. Though he may feel richer, in reality, he is not. But feeling richer, he has incurred soaring indebtedness. In 1997, the U.S. consumer owed $5,517.4 billion while having $5,988.8 billion of current disposable income. By the first quarter of 2005, his debts had almost doubled to $10,515.3 billion, comparing with an increase in disposable income by 49.5%, to $8,954.3 billion.

CARRY TRADE VERSUS SAVING

This leaves us with the "conundrum" of falling long-term rates in the face of rising short-term rates. The general explanation is that bond investors sense a slowing U.S. economy that will halt the Fed's rate hikes. We would not overrate their intelligence. This contrasts strangely with the optimism and bullishness of stock investors.

Our considerations about the outlook for U.S. asset prices start with the recognition that proper new domestic saving is nonexistent. Major changes in asset prices, therefore, depend overwhelmingly on the ups and downs of carry trade. "Carry trade" means to borrow at low short-term rates, as determined by the Fed, and lend or invest with high leverage at higher long-term rates.

Back to the "conundrum" that long-term interest rates have fallen even though the Fed hiked its rate from 1% to 3%. In the absence of new savings, there are only three potential big buyers: foreign central banks, U.S. banks or leveraged hedge funds. The single biggest buyer of Treasury bonds during the first quarter of 2005, according to the Fed's Flow of Funds report, were the Caribbean banking centers with an increase in their Treasury holdings from $69.5 billion to $137.2 billion. The true name of these buyers is, of course, U.S. hedge funds.

Actually, there still remains a lucrative spread in 10-year Treasury bonds of around 100 basis points. That is small in comparison to past record-high spreads. But historically, it is still on the high side. Besides, in a world desperate for financial profit, this still offers an attractive return through high leverage.

While rising short-term rates reduce the profits from the interest spread, the risk looms in rising bond yields, implying a corresponding decline in their prices. It could easily have happened, but as the whole financial community stampeded into long-term bonds to profit from the last gasp in bond carry trade, bond prices rose even higher, thus adding to the profits from the spread. It was another lucrative play. But mind you, it is a temporary play, not a long-term investment.

It is our latent nightmare what may happen then to all asset prices in the United States, also affecting, of course, markets in the rest of the world. A fire sale of unimaginable proportions could begin, with asset prices crashing across the board.

WATCH OUT FOR ASSET DEFLATION

Examining in concert the out-of-control credit and debt expansion, the poor employment backdrop and the drastic changes in the pattern of demand and output provides valuable insights to the U.S. economic and financial predicament. This approach is in line with the teachings of Austrian theory, but it rigorously contradicts conventional thinking in the United States, which trumpets the "underlying soundness and vitality of the U.S. economy."

This high-riding optimism among U.S. policymakers and economists has its obvious main reason in their propensity to focus primarily, if not exclusively, on the consumer price index as a key measure of economic health. In their eyes, the coincidence of low "core" inflation with fairly strong economic growth, as measured by real GDP, in the past several years has been compelling proof to them of the U.S. economy's excellent constitution.

Virtually nothing else matters for them. This narrow perception has its correlation in the complete disregard of the huge imbalances that have accumulated in the U.S. economy and its financial system, such as the literal collapse of personal and national saving, the huge current-account deficit and the horrendous divergence between booming consumer spending and lagging business fixed investment.

For most people, as earlier pointed out, the economic reality since 2000 has been stagflation. But the mantra of stellar gains in real GDP and productivity is being used to convey the impression of a superior U.S. economic performance. Yet there is no merit in the two statistical aggregates unless accompanied by improvements in other kinds of performance such as real incomes, inflation or investment. Just by themselves, they are meaningless. In addition, the public perception is systematically clouded by clever, often selective, presentation and unfair comparison with other countries.

There is a widespread view that asset markets are basically safe because there is such an abundance of liquidity around the world. This is one of the greatest and also most dangerous illusions. It is a historical fact that every major economic and crisis was preceded by an apparent vast excess of liquidity.

A recent report published by the Bank of Japan said: *"Among these developments, mild deflation of less than 1% per annum has attracted public attention. However, we should stress that asset price deflation is deemed far more significant than mild deflation. Stock prices plunged in the early 1990s, and have since followed a downward trend, albeit with continual ups and downs. Land prices started declining with a two-year lag relative to stock prices, and subsequently have kept declining at an annual rate of around 10%."*

Assessing the state of liquidity, we make a strict distinction between two different sources: earned liquidity and borrowed liquidity. In the case of private households, earned liquidity accrues from savings out of current income and in the case of the businesses from depreciations and retained earnings. What we see in the United States is nothing but precarious, borrowed liquidity.

We keep reading that financially, U.S. private households are in their best shape ever. On closer look, they are in disastrous shape. The key measure for this rosy assessment is the sharp increase in "net worth" (assets at

market values minus liabilities) over the four years 2000-04 from $41,959 billion to $48,466.5 billion.

We dare to point out that all of this fabulous wealth creation is founded on just two premises. The one is the wildest credit expansion in history, and the other one is blind hope for the "greater fool" paying a higher price in the future. While rising yields are completely missing, mortgage liabilities of homeowners since 2000 have soared by 61% to $7,768.6 billion, implying a steep jump in interest service to be met from grossly lagging real income growth.

Declining real income growth versus soaring debt growth is the one writing on the wall for the U.S. economy. A looming liquidity collapse is the other one. To repeat: all the liquidity you see in U.S. markets and balance sheets is borrowed liquidity that has mainly accrued from the huge housing bubble and the even bigger carry-trade bubble. Liquidity from cash flow or savings is nonexistent. Manifestly, the end of the two bubbles will be the end of the U.S. economy's two liquidity sources.

For the United States to have sustained economic growth manifestly depends crucially upon much stronger business fixed investment. Distinctly strengthened corporate balance sheets and sharp recoveries in profits are widely regarded as its precursor.

Our reading is quite different. Scrutinizing the financial data for recent quarters in the Fed's Flow of Funds Accounts, three major items greatly irritate us: first, a sudden steep decline in depreciations apparently reflecting the expiration of the tax benefits; second, surging debts; and third, soaring net purchases of equities. Plainly, boosting share prices through such purchases enjoys absolute preference to investment spending.

CONCLUSIONS

Soft landing or hard landing, both start with a short period of economic weakness. Economic data across the industrialized countries commonly show slowing economies. In the U.S. case, though, it immediately became the consensus view that this can only be a soft patch, while weak economic data for Europe are just as promptly registered with gloomy comments about the future outlook.

The global economic and financial system is at risk for serious disruption because of an inordinate build-up of debt, the Bank for International Settlements, the central bankers' bank, warns in its just published annual report. The troubling signs range from record housing prices, soaring indebtedness, unusually low bond yields to an ever-widening U.S current-account deficit. Yes, but the main source of all these excesses and imbalances is unprecedented credit excess made in the United States.

For sure, the global economic recovery from the 2001 recession has peaked. The speed and depth of the impending downturn and repercussions in the financial markets is the new big question. While the Anglo-Saxon bubble economies have enjoyed higher GDP growth over the past few years, their grossly imbalanced growth makes them prone to sharp setbacks. Savage deflation of asset markets overblown with borrowed liquidity is the paramount danger.

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